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CURRENCIES AND CREDIT MARKETS

No. 259 / November 1994

"Causa remota of the crisis is speculation and extended credit; causa proxima is some incident which snaps the confidence of the system, and leads people to move back into cash. As for timing, it is an art. That says nothing — and everything."

Manias, Panics and Crashes, Charles P. Kindleberger

HIGHLIGHTS

The war of nerves continues, both on Wall Street and globally. Stock markets have turned twitchy, seesawing violently on each stray bit of economic news. Inflation, supposedly gathering strength in the United States, remains the obsessive fear.

Yet the bulls cling to hope, despite renewed declines in both bonds and the dollar. Soon, the bullish mantra goes, the Fed's preemptive interest-rate hikes will bring the U.S. economy in for a soft landing, clearing the way for a renewed boom in 1995.

In our view, these are nothing more than wishful delusions. The Great Financial Bubble has been mortally wounded. Confidence is steadily ebbing, as markets continue to move sideways or down. The real danger — of a savage liquidity panic — looms larger.

We see unsettling parallels between current U.S. financial and economic conditions and those prevailing in Japan during the late 1980s. Then, as now, excessively lax monetary policies paved the way for runaway asset inflation — and explosive credit growth.

As we explain, such debt abuses always have disastrous consequences for real economies. In Japan, they fueled a capital spending boom of staggering — and unsustainable — proportions. Inevitably, the bursting of the bubble triggered a painful retrenchment.

Now the United States finds itself on the brink of a similar disaster. The key difference: While Japan's bubble facilitated an investment-led boom, U.S. credit excesses largely have served to finance an orgy of consumption.

Ultimately, the U.S. bubble will go the way of its Japanese predecessor. As asset values plunge, liquidity will vanish. But for the United States, with its crushing debt burdens, low savings, and chronic balance-of-payments deficits, we think the consequences will prove even more severe than they have in Japan.

For global markets, the implications are equally ominous. In recent years, U.S. investors have been the main source of international liquidity, just as the Japanese were during the 1980s. A U.S. collapse likely will be the forerunner of a worldwide contraction.

U.S. AND JAPANESE BUBBLE ECONOMIES

While the carnage in the bond markets and the dollar's persistent slide have caught the markets napping, it is remarkable how lightly this two-fold blow has been taken so far. Perplexity almost seems to outweigh anxiety. There remains a widespread conviction in the markets that both movements are not justified by the fundamentals and therefore must sooner or later correct themselves.

Still, the former bullish mood is gone. But neither is there a pronounced bearishness. While the bulls are frustrated, the prevailing mixture of confusion and wishful thinking leads them to take a wait-and-see stance. The possibility of a market crash in the current environment remains unimaginable to most investors. Indeed, prevailing opinion continues to hold that the big downside risk is that of missing the inevitable, coming rally.

The nub of the bull case for such a 1995 rally is that inflation worries are the only problem presently weighing on the U.S. markets. But, the story goes, the Fed's early, preemptive-rate hikes already are taming the dreaded inflation dragon. Sooner rather than later, inflationary pressures will ease as the U.S. economy slows. With Fed policy then on hold again, the scene will be set for a strong rally in bonds. This, in turn, will reignite the bull market in equities.

Indeed, the positive surprise in the financial market so far this year has been the astounding resilience of stocks to the vicious bear market in bonds. The conventional explanation is that stock markets almost everywhere stand to benefit from a coordinated, worldwide economic recovery, engulfing the globe after years of recession and stagnation. What's more, this recovery is widely hailed as being particularly friendly for financial markets, as the existence of considerable slack in worldwide capacity utilization and persistent low wage growth are seen as promising strong profits and low inflation — even in the United States, thought to be most vulnerable to a cyclical surge in inflation.

THE DOW ILLUSION

The uglier truth is that the "strong Dow" on which the investing public, both U.S. and international, tends to focus, is masking widespread, frightful losses. According to a report from Merrill Lynch, no less than 98% of the stocks on the Big Board are off at least 10% from their highs. Roughly 78% are down 20% or more, 45% are off 30% or more, and over 10% have been cut in half — or worse. Stocks traded on the Nasdaq or the American Stock Exchange have performed even more poorly.

The contrast between hyper-bullish market talk and bearish performance is truly stunning and historically unprecedented. A recent poll by *Barron's* magazine found that portfolio managers are presently more bullish than at any time since a previous survey in February. Their main bullish argument: Corporate earnings should remain strong at least though next year, even if year-over-year gains do taper off by mid-1995.

Reading the bullish reports, what amazes us is the complete neglect of the question of where the money is going to come from to finance the predicted boom next year. It seems the bulls believe that money will rain from the sky, as long as inflation stays low. But bullishness alone doesn't make a bull market. Liquidity is the key. Our own downbeat opinion about global bond and stock markets is grounded in the very negative trends in overall liquidity, primarily in the United States. In August, net inflows into U.S equity mutual funds totaled a strong $14.4 billion, bringing the year-to-date flows to $98.1 billion. This

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (October 28)	Month	YTD	Y-Y	Vs 12-Mos Hi	Vs 12-Mos Lo
Australia	0.4%	-7.0%	-2.7%	-13.6%	3.3%
Canada	-1.9%	-7.6%	1.3%	-7.0%	8.3%
France	0.0%	-16.0%	-13.2%	-19.1%	4.5%
Germany	-1.3%	-10.0%	0.1%	-10.2%	4.1%
Hong Kong	-3.2%	-21.1%	4.1%	-23.1%	12.1%
Japan	1.5%	13.7%	1.7%	-8.1%	23.2%
Mexico	-7.0%	-1.2%	30.0%	-10.7%	33.4%
Spain	-1.5%	-11.9%	-7.1%	-19.9%	3.0%
U.K.	1.5%	-9.8%	-2.5%	-12.4%	7.2%
U.S.	1.9%	1.6%	1.3%	-1.7%	7.9%

Source: FTA Indices

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (October 28)	Current Rate (%)	Month	YTD	Y-Y	Vs 12-Mos Hi	Vs 12-Mos Lo
Australia	10.45	15	377	395	0	408
Canada	9.06	19	243	223	-38	272
France	8.31	23	267	230	-9	269
Germany	7.57	9	204	165	-19	204
Japan	4.87	23	156	121	-9	161
Spain	11.20	24	319	273	-23	350
U.K.	8.67	-14	257	184	-36	258
U.S.	7.80	22	201	242	-9	242

Source: Financial Times

Exchange Rates

Versus U.S. Dollar, % Change

Country (October 28)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos Lo
Australia ($)	1.35	0.0%	8.2%	10.0%	-0.1%	11.2%
Canada ($)	1.35	-0.1%	-1.5%	-2.3%	-4.7%	3.6%
France (FF)	5.17	2.5%	12.7%	11.8%	-1.4%	13.5%
Germany (DM)	1.51	2.6%	13.2%	10.1%	-1.3%	14.2%
Japan (Yen)	97.3	1.7%	13.0%	11.2%	-0.5%	14.0%
Spain (Pta)	125.6	2.3%	12.3%	6.4%	-1.3%	13.7%
U.K. (Sterling)	1.62	3.2%	10.1%	8.7%	-1.2%	11.0%

Source: Financial Times

is ahead of the $86.6 billion pace seen in the comparable 1993 period, but well below the record-high levels of the second half of last year. But much of this year's inflows — no less than 38% — has been diverted into international and global funds.

The fact that the U.S. market has essentially moved sideways this year, despite the continuing mutual-fund inflows, is an extremely ominous sign for the bulls. Even a third-quarter surge in merger-and-acquisition activity, totalling around $60 billion and financed largely out of cash flow and borrowings of listed companies themselves, could only give the market a temporary lift. Clearly, much if not most of the new money coming into the market simply has been withdrawn from it by sellers. Among financial institutions, private pension funds have been conspicuous sellers.

LIQUIDITY CRUNCH AHEAD

Proliferating signs of financial strain leave us no doubt that the U.S. economy and markets are heading for a serious liquidity crisis. This also is bound to hit financial markets around the world. After all, Wall Street always has been their bellwether. But this time, Wall Street's influence is bigger than ever. In recent years, U.S. investors have been the leading buyers in world financial markets, just as Japanese institutions were in the second half of the 1980s. We find the parallel quite alarming.

It is customary today in Japan, even in official circles, to refer to the financial mania of the late 1980s as the "bubble economy." But this is strictly hindsight. Before the bubble definitively burst in 1990, financial experts around the world were in complete agreement: The explosion in Japanese asset prices, they said, was different from the usual speculative manias in that it had extremely solid and sound underpinnings in Japan's low inflation rate — less than 1% — and high savings rate.

In the second half of the 1980s, Japanese investors gobbled up assets around the world, resulting in capital outflows of roughly $730 billion. This far exceeded Japan's cumulative current-account surplus during the

period of $488 billion. U.S. financial markets, with their singular depth and liquidity, acted as the most powerful magnet for Japanese money.

At the time, this huge outflow was attributed to Japan's prodigious savings. Unable to invest all of that vast pool of capital at home, Japan had little choice but to export the surplus, the experts said. Yet it was obvious right from the beginning that the Japanese money deluge flooding world asset markets was more the result of rampant domestic and international money creation, driven by super-low interest rates imposed by the Bank of Japan.

Japan's banking system lay at the heart of this liquidity boom. Banks were, and still are, the main engine of credit and money creation in Japan, unlike in the United States, where nonbank institutions have made deep inroads. For most of the late 1980s, Japanese banks delivered double-digit money growth. Japanese borrowers also went on a rampage in the Euromarkets.

Their favored instrument: Medium-term bonds, denominated in dollars, with equity warrants. The warrants gave bond holders the right to buy, at a fixed price, new shares in the issuing company at any time during the life of the bond. In return for this perk, the bonds carried very low yields — usually between 1.5% and 4%. By the late 1980s, more than $170 billion of these bonds were outstanding.

Shielded from currency risk, the Japanese sellers of these bonds poured huge amounts of money into U.S. real estate and into three-to-five year Treasury notes yielding, at the time, over 8%. But, eager to finance domestic investment or speculation, Japanese corporations and other institutions also swapped dollars into yen. This allowed them to lower their borrowing costs even further. By combining spot purchases of yen with simultaneous forward sales, they could cover their exchange risk. At the same time, they gained an interest-rate advantage of 5% — equal to the differential between short-term dollar and yen rates. Their capital costs turned negative — in effect, lenders paid them to borrow their money.

THE BUBBLE BURSTS

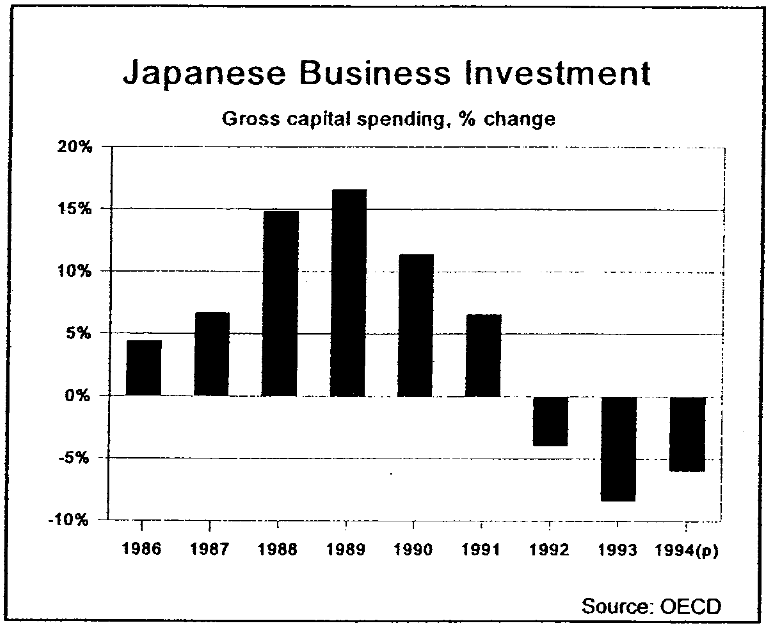
As with all good things, this happy state of affairs had to end. In 1989, under its new governor, Yasushi Mieno, Japan's central bank started tightening monetary policy, with the declared aim of puncturing the bubble before it burst of its own accord at even higher and more damaging heights. But nobody was prepared for the havoc that this pricking of the bubble was to cause to Japan's economic and financial system.

What happened? An overall balance-sheet adjustment, involving the deflation of all the aggregates inflated by the bubble, save one: the outstanding accumulated debts. While the value of collateralized assets collapsed, debt levels remained constant, spelling disaster for debtors and for the overall financial system. They were the most spectacular victims of the bust.

But bubbles don't occur in isolation from the real economy. The longer they last, the more they tend to spill over into a borrowing binge to finance business investment and/or consumer spending. In Japan's case the brunt of this money went into commercial construction and into new factory plant and equipment. These two sectors were inflated to levels that simply were not sustainable over the long run. Capital spending alone accounted for two-thirds of Japan's GDP growth during the bubble years.

All in all, it was a classic example of the way in which financial bubbles, over time, distort and damage real economies. The existence of artificially cheap credit disrupts both the demand and the supply structure, eventually forcing a prolonged retrenchment in the unduly inflated sectors. In Japan's case, the

extremity of the financial excesses ruled out a mild correction. When the bubble burst, the economy slid into something close to an outright depression.



The key depressant: A near collapse in capital spending, which switched from double-digit annual gains in the late 1980s to near double-digit decreases in the early 1990s. While this decline has slowed, it has not yet stopped. In fact, we would say Japan is the one country in world where really vicious deflationary pressures are at work. The abrupt slump in investment has been coupled with an equally dramatic slump of bank lending. Money growth has collapsed. The yen's sharp appreciation since 1990 has only served to aggravate the slump, and slow the adjustment process.

These facts are not lost on Japanese policymakers, as they have seen repeated predictions of economic recovery fail to materialize. They've become increasingly cautious about proclaiming an end to the slump, even as some indicators have hinted at a slight upturn. "We at the Bank of Japan feel that we still need time to determine whether the recent signs of improvement in economic activity will become sustainable and will permeate throughout the economy," Mieno recently said.

THE YEN MUST RISE

This dismal state of affairs has direct consequences for the currency markets. For reasons we have never understood, it has long been the consensus view that the yen must fall against the dollar, despite Japan's huge current-account surplus. The linchpin of this argument appears to be the widening advantage in short-term interest rates — presently more than 3% — enjoyed by the dollar.

In our view, the dollar bulls grossly overrate the influence of relative interest rates on exchange rates. Admittedly, the experience of the 1980s would seem to support them. Then, countries with big current-account deficits often had the strongest currencies, thanks to the higher interest rates prevailing in those countries through much of the decade.

But the decade of the 1980s was an anomalous period in financial history. The normal pattern has always been that surplus countries have strong currencies with low interest rates, while deficit countries have weak currencies with high interest rates. For much of the postwar period, Japanese interest rates — and German rates, too, for that matter — were well below U.S. rates. Yet the dollar fell during that time.

The predominant influence of interest rates during the 1980s depended on one crucial condition: A general neglect of currency risks. As money flooded into high-rate deficit countries, it became a self-fulfilling prophecy that those deficits, however large, didn't matter for the strength of the currencies being purchased.

It would astonish us if the recent market turmoil hasn't shattered or at least badly shaken this belief. Investors in the high-yielding bonds of the deficit countries have been big losers this year — both on exchange rates and on the bonds themselves. Many have suffered capital losses of 30% or more.

THE DOLLAR'S BLEAK FUTURE

Which brings us back to the dollar and the yen. Given Japan's persistently huge current-account surplus — now running about $130 billion a year — the predicted fall of the yen can only happen if Japanese investors begin a new rush into dollar assets, creating a capital outflow greater than Japan's current surplus.

This is hardly likely. Japanese institutions have lost trillions of yen on their U.S. assets. Many have suffered equally grievous losses on their domestic investments. Now, gripped by Japan's liquidity crunch, few have either the means or the inclination to embark on another U.S. shopping spree. Even if they did, this would only lift the dollar if they abstained from hedging on their exchange-rate risk by selling dollars forward.

At least one official investor, Japan's Postal Ministry, has been doing just that — probably at the behest of the Japanese government. The Postal Ministry, which is in charge of the nation's enormous postal savings plan, recently disclosed foreign-exchange losses of $13 billion on its $65 billion portfolio of foreign securities. Nearly a quarter of those losses were incurred within the past year.

Private Japanese institutions simply cannot afford to run such losses willingly. After virtually withdrawing from foreign markets last year, they have resumed their purchases of foreign bonds, mostly U.S. Treasuries and Euro-yen bonds. But most are investing strictly in short-term Treasury maturities, and are fully hedging against the risk of further yen appreciation. From such inflows the dollar gains nothing, as the hedging counteracts any rise in dollar demand in the spot market.

It's understandable that Japanese investors would shy away from exchange risk, after suffering such terrific losses in the past. But if this becomes their new investment pattern, it will have far-reaching consequences for the global capital and currency markets. Woe then, we would say, to the U.S. dollar.

For this and other reasons, we think the yen bears are in for lasting disappointment. In an increasingly bearish world, filled with such tremendous currency uncertainty, the thought that Japanese investors would embark on a new, unhedged investment binge in dollar assets is simply absurd.

In fact, the opposite appears more likely. While capital outflows from Japan have resumed, they are but a fraction of their former size, and hardly large enough to recycle the enormous Japanese current-account surplus. To make matters worse, the rising yen, which augments dollar returns on Japanese assets, has attracted significant capital counter flows from the United States for much of the past year.

As a result, Japan has become a suction pump, sucking liquidity from the rest of the world, while returning little of it in the form of exported capital. The chief effect of this, of course, has been to put enormous upward pressure on the yen. Only the Bank of Japan's frantic dollar support operations have prevented the yen from soaring to truly catastrophic levels.

Should Japan's faint recovery falter, there is a risk that Japanese investors could be forced to resume their net selling of overseas assets to meet liquidity needs at home. This would put even more upward pressure on the yen, giving the entire deflationary process another savage twist. Truly, Japan is paying dearly for its earlier excesses.

Japan's bubble was exceptional in size. That's why it ended in a crash and in such a deep economic crisis. But it was not at all unique. Like all bubbles, its essence was the creation of excess liquidity, which inflated asset prices rather than prices for goods and services. To most people, policymakers included, the idea there could be runaway inflation in paper wealth, that is to say, in bond and stock prices, was inconceivable. Yet it had many precedents, such as the U.S. stock market bubble of 1927-29.

THE U.S. BUBBLE, 1990-94

But what of the boom that has raged in the world financial markets these past few years, which now seems to have reached its crisis point? How do we explain the boom, and how the crisis?

In the consensus view, the U.S. and world financial boom of the early 1990s was sound and healthy, solidly underpinned by low and falling inflation. The turmoil of recent months is dismissed as the overreaction of bond investors to hints of inflation and to the Fed's modest rate hikes. This is uncritically accepted, since this is the only explanation most people can imagine or understand. It has the advantage of implying a recovery, once the bond markets come to their senses.

Our views about the boom and its aftereffects, on the other hand, are extremely unpleasant and therefore unpopular. For us, the global financial boom of 1990-1994 truly was a bubble. In the current turmoil, we see the first effects of the bust, meaning the worst is still to the come.

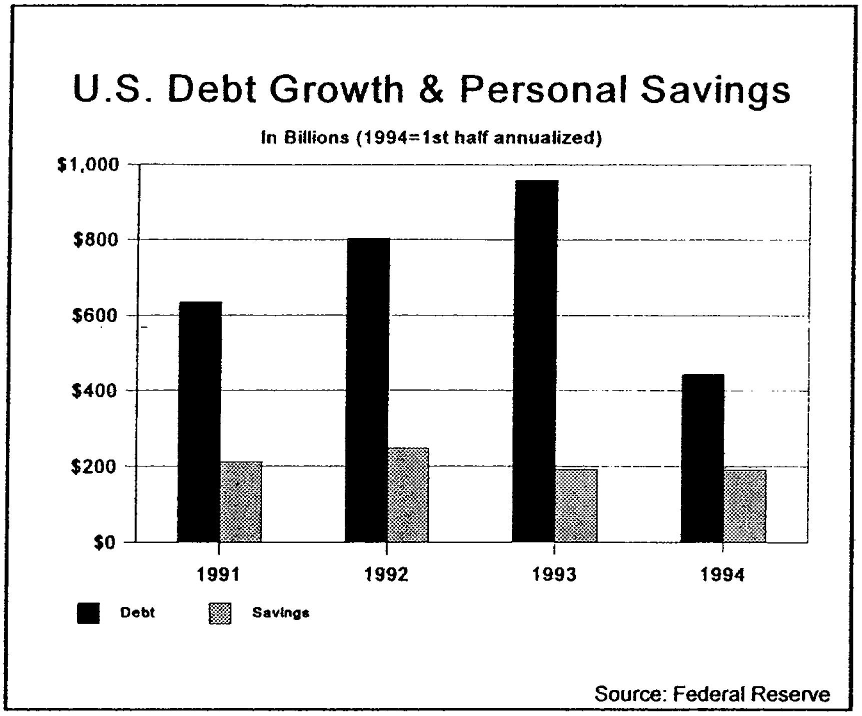
What makes a bubble? Some experts express puzzlement. In a recent speech to a New York financial group, Alexandre Lamfallussy, the president of the European Monetary Institute, said he found it difficult to even define a bubble, much less recognize one.

Until John Maynard Keynes came along, traditional monetary theory had a clear notion in this respect. The crucial distinction is whether flows into credit and asset markets resulted from increased savings, or from "inflation." Any gap between savings and the actual flows of funds essentially is filled by funds rom various potentially inflationary sources. In this concept, inflation implies either credit creation, both inside and outside the banking system, or the use of existing money balances.

Any attempt to unravel the secrets of the recent global bubble has to focus on the United States. U.S. investors and speculators have been the principal providers of funds to the world financial markets during the 1990s, just as their Japanese counterparts fueled global asset inflation during the late 1980s. History has repeated itself, although with some important differences.

To get some idea of the monstrosity of the recent bubble, one only has to compare the actual flow of funds into credit and capital markets with the amount of new savings that simultaneously has been created. According to the Fed's latest Flow of Funds report, between year-end 1990 and mid-1994, total outstanding debt — both financial and nonfinancial — in the United States grew by $2 trillion to $16.4 trillion. This doesn't include flows into mutual funds and equities, which amounted to well over another $1 trillion. It also doesn't include the even larger flows into or through the derivatives markets.

These trillions of dollars, lent or invested, far outstripped the roughly $750 billion in personal savings created during the same period. This vast difference between savings and financial flows unmistakably qualifies the boom of the past few years as a bubble — and a monstrous one.



As our long-time readers know, two questions have long preoccupied us: First, how could these huge financial flows come about at a time of zero broad money growth in the United States? Secondly, how long can they last, if money growth remains stagnant?

As we have explained in previous letters, a rise in money flows can result either from an increase in the money supply, or an increase in the velocity of circulation of the existing money stock. Clearly, the latter was the driving force behind the recent bubble.

The results: economic recovery, booming financial markets and stagnant money growth — truly an unprecedented mix in monetary history. That's why we have devoted so much time to investigating its causes and effects. Our exploration has left us convinced: The spurt of money velocity that has driven the economic recovery and the financial boom cannot last. The bursting of the bubble is only a matter of time.

THE FED'S ERROR

The total lack of concern about persistent money stagnation has its obvious cause in the widespread belief — shared by the Fed — that the trend simply reflects the well-known mass flight out of bank deposits into higher-yielding securities. This is a colossal error, as our past letters have explained in detail. Purchases of securities have no impact whatsoever on the money supply. They simply cause existing bank deposits to change hands. That's all.

We think it crucial to understand how this rise in U.S. money velocity really occurred. We have identified three main channels:

- The best-known cause was indeed the "dash from cash." The Fed's easy money policies caused millions of individual investors to switch from bank deposits to mutual funds. This created an enormous flow of money into the markets, even though it involved no credit or money creation.

- A second source of investment flows was the steady accrual of capital gains in the booming markets, gains which could be regularly converted into cash and used to buy more securities. This tremendous churning also left no trace in the money supply figures. Again, cash balances simply passed from one owner to another.

- The biggest source of cash for the markets was the third channel: A credit explosion outside the banking system. Most of this borrowing occurred in connection with yield-curve speculators, who financed their enormous bond holdings with cheap short-term money.

Though these borrowings ran into trillions of dollars, they left no trace in the money supply. Most of the loaned money didn't come from banks. This is a crucial point. Bank financing would have resulted in money creation, increasing the money supply. But the main suppliers of funds to the yield-curve speculators were securities dealers, corporations and other nonbank lenders, seeking to earn slightly higher yields on their surplus cash reserves. To repeat: These flows entailed neither money creation nor money destruction. In all three cases, existing money was put into circulation in the financial markets.

Just as clearly, these flows were completely disconnected from the supply of new savings. In other words, they were highly inflationary. They also were unsustainable over the long run. Even without a catalyst, such as a market shock, such velocity flows must eventually dry up, as asset prices rise to levels that encourage a shift back to cash balances. The Fed's timid rate hikes this year have only helped accelerate the process.

So far, there hasn't been the kind of general rush to liquidity that triggers the final crash. But the flow of money into the markets has slowed. In the bond markets, it has reversed. That's all that it takes to turn bull markets into bear markets. Indeed, signs of deteriorating liquidity are proliferating. The U.S. banking system again is in trouble — but this time the trouble is in funding (see table). This defies conventional wisdom, which holds that the Fed's rescue work has left the banking system strong and liquid. But the Fed's own bank balance-sheet reports show that trouble is brewing.

ASSETS AND LIABILITIES OF U.S. BANKS

(in billions of dollars)

ASSETS	Sept. 93	July 94	Oct. 12, 94
Bank Credit	$3,072	$3,248	$3,269
Securities	904	968	946
Loans and Leases	2,168	2,280	2,323
LIABILITIES			
Deposits	$2.,524	$2,513	$2,537
Borrowings	520	578	569
From U.S. Banks	151	162	154
From Non-banks	369	416	398
From Foreign Affiliates	126	200	209

Source: Federal Reserve

The first point to note is that bank credit has expanded quite strongly — by $197 billion — over the past twelve months. But this expansion was not matched — as is normal — by corresponding deposit growth. In consequence, the banks have had to scramble for other sources of funds.

So far, the main offset to the missing customer deposits has been Eurodollars borrowed from the banks' foreign affiliates. But while this is an easy way out, its also a precarious one, in that it increasingly exposes the lending banks to the vagaries of the currency markets. That's why this method of funding has its limits. Now, it seems the banks are retrenching. Not only has credit growth slowed sharply, but banks have turned to another alternative — bond sales — to meet their funding needs.

So far, these sales have been relatively modest. But to realize their potential impact on the bond market, one has to set them against the $341 billion in bond purchases made by the banks in 1990-92. This orgy of yield-curve playing, aided and abetted by the Fed, was one of the major props supporting the bull market in bonds. Now that the banks have turned from net buyers to net sellers, we think another downward leg in the bear market is inevitable.

The great mystery in all of this has been the massive accumulation of dollars by foreigners. As Eurodollar rates offer them no advantage, except over yen rates, this can only be a currency play — in other words, a huge bet on a rising dollar. Far from capitulating, the dollar bears have raised their stakes, even though dollar forecasts have become progressively less bullish as the year has progressed. The consensus forecast remains for an eventual recovery, albeit from steadily lower levels.

Given the dollar's persistent slide over the year — down 13% against both the yen and the DM — most of these dollar holders must be deep in the red. But unwilling to accept these losses, the bulls maintain their positions, or even raise them, apparently in the belief that after so much carnage a major rally is overdue. Yet we have to wonder: How can such a rally occur when there are so many frustrated dollar bulls eager to sell into it?

In hindsight, conventional wisdom blames the dollar's plunge on unexpectedly strong U.S. GDP growth, which has fueled inflation fears. This is paradoxical to say the least, given that for many years the standard argument held a touch of inflation was good for the greenback because it augured a monetary tightening by the Fed. Now, the bullish script holds exactly the opposite. The dollar is said to be headed for recovery on the back of low inflation and stable or rising bond prices, as the U.S. economy settles into an ideal pattern of steady growth in line with its potential rate of 2% to 2.5%. To perpetuate their lucrative bullishness, Wall Street's so-called experts change their theories the way other people change their shirts.

Our own script for the markets and the dollar has not changed at all, except on one minor point. Owing to a massive inventory buildup, U.S. economic growth has held up better than we expected, at least in the short-run. But the medium-term outlook is still decisively negative. This recovery remains extremely lopsided, and haunted by dismal liquidity trends.

A TALE OF TWO BUBBLES

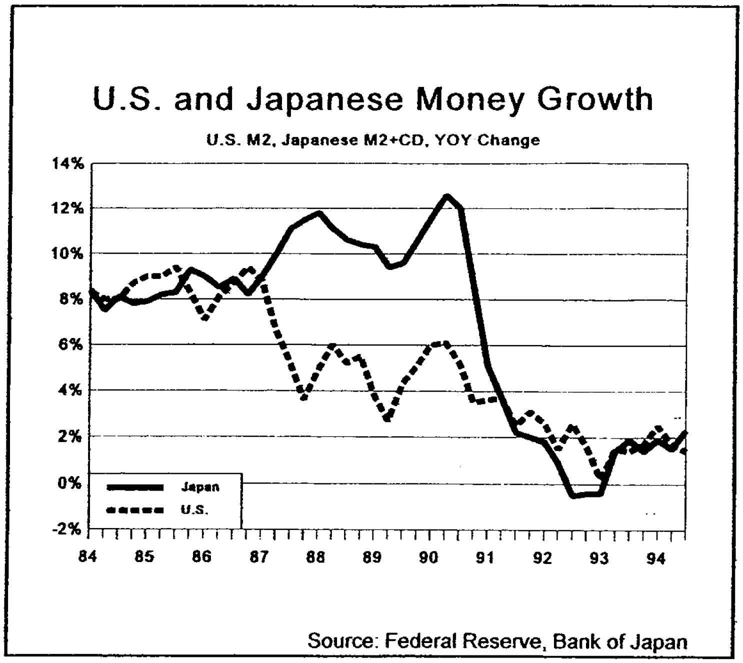
The parallel with Japan is obvious: In each case, a financial bubble inevitably evoked tremendous distortions in the real economy. But, just as America's huge current account deficit is the counterpart of Japan's huge surplus, the two bubbles also are mirror images of each other. In Japan's case, the inflated spending triggered by the bubble of the late 1980s primarily poured into business investment and commercial construction. In the United States, the bubble of the 1990s fueled a new borrowing and spending binge by the consumer.

Since first quarter 1993, increased consumption has accounted for no less than 77% of the expansion in overall GDP. During the 1982-90 expansion — itself badly distorted — consumption was responsible for just 68% of GDP growth. Such a consumption binge is always the precursor of a hard landing.

The central problem of every asset-price bubble is the massive illiquidity and wealth destruction that inevitably ensues when the bubble bursts. After all, it was the spectacular Wall Street crash of 1929-30 that turned a potential recession in the United States into a depression. Now, the Bank of Japan admits its efforts to reliquify the economy are being overwhelmed by the savage downward pressure from bubble-related balance sheet adjustments, and their rampaging destruction of asset values and liquidity.

Indeed, Japan is the one country in the world that has come closest to the brink of overall deflation, as reflected in the collapse of credit and money growth. Despite the reflationary efforts of the central bank, liquidity creation has remained extremely depressed. And, as opposed to the United States, there is no money velocity miracle to offset the liquidity crunch.

How does the U.S. bubble economy compare with its Japanese counterpart? On the surface, in terms of valuation excesses, it appears much more moderate. But that's the one and only positive factor in the United States' favor. On the other hand, America is faced with two powerful negatives: a paltry savings rate, and a chronic balance-of-payments deficit.



A U.S. gross savings ratio of 15% of GDP compares with a corresponding ratio of 35% on the part of Japan. These figures include personal savings, business savings and capital depreciation. At the same time, Japan's $130 billion current-account surplus compares with a U.S. deficit now running at an annual rate of $148 billion.

The importance of current savings and the balance of payments lies in their inherent liquidity effects. With its high savings ratio, Japan is internally generating an enormous flow of "owned" liquidity, in contrast to liquidity that is simply generated through the creation of bank credit. In addition, enormous liquidity continues to pour into the Japanese economy via its huge trade surplus and the purchase of Japanese shares by American investors. But this fails to translate into economic recovery, as the country's bubble-damaged financial system continues to retrench. Liquidity is literally vanishing into thin air.

In the United States, we see diametrically opposite liquidity trends. While the Fed's modest rate hikes have partially deflated the financial bubble, it has not yet affected the real economy. Above all, the public's liquidity preference remains abysmally low. The "cash is trash" syndrome still reigns supreme. This perpetuates the mirage of excess liquidity, even though an unprecedented liquidity crunch is in the making.

THE COMING STORM

The signs of this approaching crisis are multiplying. As we mentioned, current debt growth exceeds current money growth as never before. The U.S. balance of payments deficit remains a persistent massive liquidity drain. More recently, this leakage has been boosted by capital outflows. This has left the U.S. banking system heavily dependent on Eurodollar borrowing to sustain credit growth, exposing the banks to the vagaries of the currency markets.

What will it take to trigger the inevitable — and disastrous — flight to liquidity? We cannot say, just as it is impossible even in hindsight to pinpoint what specific event unleashed the tide of selling that brought the Japanese stock market crashing down in the winter of 1990.

We can say this: The death knell of any bubble is the growing reluctance of investors to commit new cash to a market that seems to have lost its irresistible upward momentum. This has already happened. The longer the markets move sideways — or down, as in the case of the dollar — the weaker the bubble becomes. The final blow could come from any direction. It's only a matter of time.

CONCLUSIONS

U.S. liquidity conditions continue to deteriorate, as evidenced both by declining inflows into the financial markets, and by the beginnings of a balance-sheet retrenchment by the banks. Three things stave off the final disaster:

- Many of the speculators burned in this year's bond crash persist in holding their positions, in hopes of a rally that will cut their losses.

- Small investors apparently continue to regard yields on money-market instruments as too low to merit a major switch back to cash — even though yields on stocks and bonds this year have been abysmal.

- Foreigners are showing a surprising willingness to hold dollar assets, despite the profound fundamental forces driving the dollar to steadily lower levels.

None of this can last. As hopes of recovery fade, taking with them the prospects of future capital gains, cash yields will look progressively more attractive. Eventually, investors will capitulate. The rush to the doors will begin in earnest.

We retain our strong preference for safety and liquidity. We recommend that investors focus only on cash and shorter-term bonds of the hard-currency countries — Germany, Switzerland, Austria and the Netherlands.

Currencies & Credit Markets

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Fax: (905) 957-0602

Subscription Rates:
North America, US$ 400
Outside North America, DM 600
Published monthly.